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IN THE

Supreme Court of the United States

October Term, 1950.

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No. 631

CONSUMER-FARMER MILK COOPERATIVE, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit and Supporting Brief.

MARK H. JOHNSON,
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CONSUMER-FARMER MILK COOPERATIVE, INC.,
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vs.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

To the Honorable Fred M. Vinson, Chief Justice of the United States, and the Associate Justices of the Supreme Court of the United States:

Your petitioner respectfully prays that a writ of certiorari be issued to the Court of Appeals for the Second Circuit to review the judgment of that Court.

Statement of Matter Involved.

By this petition review is sought of the claim for tax exemption made by the petitioner on the basis of its dedication to the improvement of conditions in the milk industry. The petitioner has contended that it is a tax-exempt "civic organization" within the meaning of section 101(8) of the Internal Revenue Code; but the Court of

Appeals, by judgment entered December 27, 1950, affirmed a decision of the Tax Court, entered Setember 13, 1949, denying such exemption and sustaining deficiencies in the petitioner's excess profits tax and declared value excess-profits tax for the fiscal year ended September 30, 1943, in the respective amounts of $23,821.32 and $439.41.

Summary of Facts.

These are the main facts as found by the Tax Court (R. 4-13), with additions from the original transcript (Tr.):

Petitioner is a non-stock cooperative corporation under the laws of New York, and operates a milk business in conjunction with its efforts to improve the milk industry for the benefit of both the farmers and consumers in the area of the City of New York. It has no stockholders; but any person may become a consumer member upon the payment of a 25 cent membership fee; and members of farmers' associations from whom the organization purchases commodities also become members upon the payment of a like fee. The very purpose of organizing the petitioner as a cooperative was to stimulate the interest of the public in milk problems through the cooperative movement (Tr. 85). In this way membership could be made available to anyone on unlimited terms, without stockholdings (Tr. 77); and the public, which was responsible for petitioner's existence and would continue to be responsible for its support, could maintain control of the election of its board of directors (Tr. 84).

Petitioner was an outgrowth of the Milk Consumer's Protective Committee, which had been formed in 1936 primarily by a group of welfare organizations to protect the public's interest in milk distribution and milk regulation.

The need for such a committee was obvious. This Court has long recognized that the milk industry is affected with a public interest. *Nebbia* v. *People*, 291 U. S. 502. That case dealt with milk control legislation, by way of justification wherefor the New York legislature said:

> "It is hereby declared that unhealthful, unfair, unjust, destructive, demoralizing and uneconomic trade practices have been and are now carried on in the production, sale and distribution of milk and milk products in this state, whereby the dairy industry in the state and the constant supply of pure milk to inhabitants of the state are imperiled. That such conditions constitute a menace to the health, welfare and reasonable comfort of the inhabitants of the state." N. Y. Laws of 1933, Ch. 158, §300.

The 1937 report of the New York State Attorney General, in the record as Exhibit 7, is further evidence of the public outcry against practices rampant in the milk industry.

This was the atmosphere in which the Milk Consumer's Protective Committee was formed. It directed itself principally to the goal of eliminating the spread between the farmer's price and the cost to the consumer, both by raising the farmer's return and lowering the retail price. In this connection it worked for the repeal of minimum retail price fixing provisions in the New York law, participated in investigations into simultaneous price increases by the major distributors, and studied and published findings on the lack of justification for the premium charged for Grade "A" milk offered to consumers in the New York City area. It also studied the problem of underconsumption of milk.

By November 1937 the Committee represented more than 60 civic, welfare, labor, religious, consumer, and farmer organizations with a membership of almost one million people. At a meeting of the Committee called at

that time it was decided that the objectives of the Committee could be best accomplished and advanced by the creation of an active milk distributing company operating in the interests of the public, which could actually achieve a minimization of the price spread between the farmers and consumers it served, and which could serve as a yardstick for prices and practices in the industry generally (Tr. 85-86, 138). Therefore, the petitioner was organized to take over the work and activities of the Committee. Testifying to this at the trial were such of petitioner's organizers as Helen Hall, leading social worker, Mildred Gutwilig, outstanding educator and welfare worker, and also two cabinet members in the administration of Mayor Fiorello H. LaGuardia, a director of the National Farmers Union, and a churchman.

The petitioner's milk business is operated to return a reasonable profit which, after reserves, is devoted both to the civic work of the organization and to the payment to the consumer and farmer members of patronage dividends. The petitioner's works in achieving reforms in the milk price structure have included: a study and campaign leading to the elimination of Grade "A" markings on milk sold in the New York City area; a program to discourage the purchase of so-called "high-test" milk, as economically and nutritionally unsound; opposition to minimum retail price-fixing provisions in the state and federal laws, as tending to destroy competitive conditions; continuous reexamination of and giving of testimony in regard to adjustments in the complex price formulas used to fix the blended price of milk to be paid to farmers; constant checking of the commodity markets for evidence of rigging in the prices of butter, cheese, skim milk powder, etc., and the reporting of such practices to the appropriate governmental authorities; demonstration by its own experience of the unreasonableness of the premium charged for milk in "paper" containers, as compared

with milk in bottles; a study and campaign to eliminate the premium charged for "homogenized" milk, which has included the presentation of statistics to the Department of Health and the education of the public through pamphlets; adoption of a price policy, which is unique in the industry, of passing on to special types of purchasers, such as settlement houses, churches, and similar community service organizations, economies resulting from the volume and type of service required by such purchasers.

There are other ways in which the petitioner acts as a useful public servant. It works to increase milk consumption in the community generally, and especially in the low income areas, by serving "milk stations" at health clinics for poor families, and at low-cost housing developments. It has participated in subsidized school milk programs; and during the last war it serviced a navy yard and started a stage door canteen milk program. It carries on an extensive educational program concerning the milk industry for farmers and consumers, including: the distribution of its own publications and the reprinting of literature prepared by other groups; such activities by its officers and directors as lecturing at schools and colleges, appearances on the radio, and contributions of articles to farm journals; and financial support of the educational programs of affiliated organizations.

At this juncture, it is pertinent to call attention to the inexplicable lapse of the Court below when, in determining whether the petitioner was "operated exclusively for the promotion of social welfare", it simply balanced the costs of petitioner's educational program against the amount of patronage dividends it pays out (R. 40-41). The Court completely ignored the petitioner's numerous activities found by the Tax Court, and which are recounted above, in matters affecting prices and practices in the milk industry, which is far and away the most significant aspect of petitioner's civic work.

The payment of patronage dividends to consumer and farmer members is itself one form of implementation of the petitioner's basic objective of eliminating the spread in the milk price structure, by increasing the price paid to the farmer while concurrently lowering the ultimate cost to the consumer. For the sake of brevity, description of the mechanics of petitioner's patronage dividend policy is deferred until the discussion in the brief of its legal effect, *infra*. In actual practice only a negligible portion of the consumer dividends are claimed, and the unclaimed amounts are ultimately added back to surplus. In the determination of petitioner's tax liability for the taxable year, the Commissioner allowed a deduction from net income on account of patronage dividends paid to members.

Jurisdiction.

The jurisdiction of this Court is invoked under section 240(a) of the Judicial Code. Judgment was entered herein by the Court of Appeals on December 27, 1950 (R. 43). Petition for rehearing was not filed.

Opinions Below.

The opinion of the Tax Court, printed in full herein (R. 3-18), is reported at 13 T. C. 150. The opinion of the Court of Appeals, printed herein at R. 36-42, is reported at 186 F. 2d 68.

The opinions below form a variegated pattern of attacks on the petitioner's claim to exemption from tax. The principal ground of attack by the Commissioner was that the petitioner is a competitive commercial organization operating a business to make a profit. Both the Tax Court and the Court of Appeals expressly rejected this argument (R. 13, 39). The Tax Court made as the principal ground

for decision its conclusion that the surplus of the petitioner belonged to the members (R. 15). This conclusion was so obviously contrary to the normal *cy pres* rule controlling "charitable" corporations such as the petitioner, within the wider meaning of that term, as to prompt the directors to procure a declaratory judgment proscribing disposition of the petitioner's assets to its members, *Attinson* v. *Consumer-Farmer Milk Cooperative, Inc.*, 94 N. Y. S. 2d 891.

The Court of Appeals placed its decision on the ground that a substantial portion of the income of the petitioner inured to the benefit of its members in the form of patronage dividends, and therefore the petitioner was not "operated exclusively for the promotion of social welfare", but was in fact "organized for profit" (R. 39-41).

Specification of Error to Be Urged.

The Court of Appeals erred in denying exemption to the petitioner on the basis of this novel rule of law: the payment of deductible patronage dividends by a cooperative corporation is a profit distribution, within the prohibition of I.R.C. §101(8) relating to corporations "organized for profit"; and so the corporation cannot qualify as one "operated exclusively for the promotion of social welfare".

Reasons for Granting the Writ.

1. The decision of the Court of Appeals is in direct and acknowledged conflict with the decision of the Court of Appeals for the Sixth Circuit in *United States* v. *Pickwick Electric Membership Corporation*, 158 F. 2d 272 (1946), in its denial of exemption to a cooperative civic organization because of the distribution of patronage dividends.

2. The question decided below, as to the "profit" character of patronage dividends, is a fundamental question of tax law which has not been, but should be, settled by this Court. This question affects not only the exemption of cooperatives under I.R.C. §101(8), but also the deduction of patronage dividends by cooperatives under I.R.C. §23.

3. The decision of the court below on the "profit" character of patronage dividends is so great a departure from the long-standing Treasury rule, and the numerous cases which have approved it, as to require review by this Court.

4. The question of the effect of commercial activities on the right to exemption under I.R.C. §101(8) is an important question which has not been, but should be, settled by this Court.

5. Independent of the importance from the standpoint of the tax law of the questions stated above, review by this Court of the decision below is warranted because it threatens the continuance of the petitioner and similar cooperative social ventures, as well as cooperatives of all kinds.

Wherefore it is respectfully requested that a writ of certiorari be issued to the Court of Appeals for the Second Circuit.

Respectfully submitted,

MARK H. JOHNSON,
Counsel for Petitioner.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1950.

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vs.

COMMISSIONER OF INTERNAL REVENUE.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

Introductory Statement.

The nature of this action and the principal facts have been outlined in the petition and need not be restated here.

Specification of Error to Be Urged.

The Court of Appeals erred in denying exemption to the petitioner on the basis of this novel rule of law: the payment of deductible patronage dividends by a cooperative corporation is a profit distribution, within the prohibition of I. R. C. §101(8) relating to corporations "organized for profit"; and so the corporation cannot qualify as one

"operated exclusively for the promotion of social welfare".

Argument.

This case is but a further instance of the recent attacks on cooperatives because of their favored tax status. It raises a fundamental question of taxation affecting cooperatives generally. The specific issue involves the effect of patronage dividends on exemption of civic organizations under I. R. C. §101(8). The deductibility of such dividends under I. R. C. §23 (a question on which this Court has never passed) is not directly in issue, because the Commissioner has allowed the deduction to the taxpayer here; but it is collaterally involved because, if a patronage dividend is finally decided to be a profit distribution for purposes of §101(8), the theoretical justification for its deduction by a cooperative under §23 collapses. Conversely, of course, legal considerations supporting the §23 deduction also support the exemption under §101(8).

The holding of the Court of Appeals on the exemption issue, that patronage dividends militate against an organization's being "operated exclusively for the promotion of social welfare", is directly contrary to the rule adopted by the Sixth Circuit in *U. S.* v. *Pickwick Electric Membership Corporation*, 158 F. 2d 272, as the court below expressly acknowledged in "respectfully declining to follow" *Pickwick* (R. 42). That case concerned a cooperative nonprofit, non-stock corporation organized by Tennessee residents to bring electricity into rural districts and to furnish electricity at more reasonable rates than were charged by private companies. The cooperative sold electricity at a profit to members and also to non-members, but at higher rates. The by-laws provided that all revenues in excess of expenses, debt retirement, and necessary reserves be distributed to the members as patronage refunds, or by way

of rate reductions, or both. The case is almost indistinguishable from the case at bar, except that in the taxable year before the court resort was had to rate reductions, rather than to refunds; but the court viewed consumer dividends as an "indirect form of reduced rates".

To an argument identical to that adopted by the Court of Appeals below, the Sixth Circuit said:

> "The Government's contention is that it was not operated exclusively for that purpose (social welfare) in that its earned income inured to the benefit of its members in the form of patronage refunds or reduced rates. Patronage refunds are in substance an indirect form of reduced rates * * * Benefits through the form of rate reductions are not dividends on investments any more than any other reduction in the cost of living can be called such. Such a benefit is the result of the successful promotion of social welfare by the company. The participation on the part of the members in the benefits of such social welfare does not mean that the operations are for their individual benefit instead of for the benefit of the community * * * Non-members had the right to become members on a non-discriminatory basis and share alike in the benefits provided by the company." (Omissions relate only to the court's discussion of cases it followed or distinguished.)

In reaching a contrary result in the instant case, the court below was compelled to characterize the patronage dividends as "profit" distributions, notwithstanding its recognition of the judicially supported Treasury rule treating them otherwise for purposes of deduction under I. R. C. §23. See G. C. M. 17895, Cum. Bull. 1937-1, 56; I. T. 3208, Cum. Bull. 1938-2, 127; *Fruit Growers Supply Co.* v. *Com'r*, 21 B. T. A. 315, aff'd 56 F. 2d 90; *Midland Coop. Whole-*

sale, 44 B. T. A. 824; *United Coops. Inc.*, 4 T. C. 93; *Farmers Coop. Co.* v. *Birmingham*, 86 F. Supp. 201. The court did not criticize the rule under §23, but rather found it not "persuasive" under §101(8). In other words, in the view of the court, a taxpayer may be "organized for profit" in some restricted §101(8) sense, though not otherwise capable of being so regarded. The court obviously erred in treating §§23 and 101(8) as mutually exclusive on the profit issue. The tax law does not allow deduction of patronage dividends by cooperatives under I. R. C. §23 out of any narrow view of "profits". The theoretical justification for the deduction is stated by the Treasury as follows:

> "The practice is based on the theory that such amounts in reality represent a reduction in cost to the patron of goods purchased by him through the corporation or an additional consideration due the patron for goods sold by him through the corporation." I. T. 3208, *supra*.

If a patronage dividend is a true price adjustment, this would also foreclose a charge that a taxpayer is "organized for profit" for the purposes of §101(8), because such an adjustment could not detract from the taxpayer's promotion of social welfare.

It is submitted that the court below, in burdening the phrase "organized for profit" with a special meaning for §101(8), bent the phrase out of shape in preference to acknowledging the real conflict between its decision and the "patronage dividend" precedents cited above.

If the writ of certiorari is granted, the petitioner will argue that a cooperative is not "organized for profit" in the sense of pecuniary profit for its members, either for the purposes of §101(8) or of §23, solely by reason of the distribution of patronage dividends. The element of departure from ordinary corporate dividends is found in the

fact that the financial gain is enjoyed by the members in exact proportion to the business transacted with the cooperative during any period, rather than in proportion to capital contributed to the corporation. This difference of economic principle governing the allocation of income is fundamental. It is not merely a technique to distribute to the members the profits earned by the cooperative generally, only substituting volume of patronage for number of shares owned.

The consumer and farmer dividends paid by the petitioner are themselves good illustrations of the nonprofit character of patronage dividends. Annual declaration of such dividends is obligatory upon the petitioner, by reason of its by-laws and directors' resolutions—a fact often noted in the cases sustaining deduction for patronage dividends. See *Fruit Growers Supply Co., supra; Midland Cooperative Wholesale, supra; United Cooperatives, Inc., supra.* The by-laws leave determination of the actual amount of dividends to the directors, but require them to be uniform in direct proportion to business done with each consumer or farmer member, and in the case of consumer dividends, provide that "such dividends shall not exceed the difference between the cost of producing these purchases and their selling price". It is further required that consumer dividends be declared in twice the amount of farmer dividends. Being thus related to consumer dividends, the farmer's dividend too can only be derived from the spread between the cost and selling price of the units furnished by such farmer; and no farmer can share in the profit made by the petitioner on the sale of units supplied by any other farmer. A directors' resolution effective for the taxable year authorized farmer dividends of 7½ cents per 100 quarts of milk sold through the petitioner, and consumer dividends of 15 cents per 100 quarts of milk purchased from the petitioner.

We anticipate that the respondent will argue (as he has before), in opposing the granting of this writ, that even if the patronage dividend is not a disqualifying profit distribution, the petitioner is nevertheless "organized for profit" solely by virtue of the fact that it was engaged in a business ordinarily carried on for profit, and itself made a profit in its operations. Both of the lower courts have rejected this as a basis for denying exemption to the petitioner, as have all the courts which have considered the question in relation to exemption under §101(8). See *Garden Homes Co.* v. *Com'r*, 64 F. 2d 593; *Hanover Improvement Society, Inc.* v. *Gagne*, 92 F. 2d 888; *Debs Memorial Radio Fund, Inc.* v. *Com'r*, 148 F. 2d 948; *U. S.* v. *Pickwick Electric Membership Corporation*, 158 F. 2d 272.

This has also been the rule of the cases under I. R. C. §101(6), relating to the exemption for charitable and educational corporations. *Roche's Beach Inc.* v. *Com'r*, 96 F. 2d 776; *Com'r* v. *Battle Creek, Inc.*, 126 F. 2d 405; *Bohemian Gymnastic Association Sokol* v. *Higgins*, 147 F. 2d 774; *Com'r* v. *Orton Ceramic Foundation*, 173 F. 2d 483; *Willingham* v. *Home Oil Mill*, 181 F. 2d 9, cert. den. 340 U. S. 852; *Unity School of Christianity*, 4 B. T. A. 61; *Sand Springs Home*, 6 B. T. A. 198. Two recent cases do not represent repudiations of the basic rule, but involve the introduction of novel interpretations of subdivision (6) of §101 on facts and statutory language which are entirely absent from the present case. See *Mueller* v. *Com'r*, 14 T. C. 922, appeal pending C. A. 3rd (involving the problem of a "feeder" organization); *Universal Oil Products Co.* v. *Campbell*, 181 F. 2d 451, cert. den. 340 U. S. 850 (involving the problem of a corporation originally organized for private profit).

By the Revenue Act of 1950 Congress expressly provided for the taxation of the business income of certain organizations exempt from tax under §101(6), thus modi-

fying the rule of the above cases prospectively for taxable years beginning after December 31, 1950. See I. R. C. §421, added by Rev. Act of 1950 §301(a). However, the new legislation is deliberately inapplicable to organizations exempt under subdivision (8) of §101, *inter alia*. Therefore, the problem is a continuing one for §101(8) organizations, and if the anticipated argument of the respondent is any indication of uncertainty in the law, this Court may wish to settle this question by granting the writ.

Conclusion.

Because the decision of the Court of Appeals is in direct conflict with the decision in another circuit on the identical issue, and because the questions decided below are fundamental to the taxation of cooperatives as well as civic organizations and have not been passed upon by this Court, and because the decision below represents a substantial departure from precedent, it is respectfully requested that certiorari be granted.

Respectfully submitted,

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